CalPERS
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
Telecommunications Device for the Deaf - (916) 795-3240
(916) 795-3400

March 16, 2009

AGENDA ITEM 5b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Asset Allocation Preview

II. PROGRAM: Total Fund

III. RECOMMENDATION: Information only

IV. ANALYSIS:

The purpose of this item is to discuss the issues relating to the 2009 Asset Allocation review and to seek input and direction from the Committee. Staff will then present asset mix options and recommendations in May 2009 for Committee decision. Should the Committee decide to adopt new policy targets and ranges in May, this will then be incorporated into the Statement of Investment Policy for Asset Allocation Strategy with a new effective date.

Background

At the December 2008 meeting, the Committee directed staff to conduct a review of the Asset Allocation Policy targets primarily to address liquidity needs and that projected Alternative Investments (AIM) allocations will substantially exceed the current policy target of 10% and be out of range in the coming year. This projection was based on current unfunded AIM commitments of $23.6 billion.

Extreme market volatility and illiquidity in the fourth quarter of 2008 caused CalPERS to raise cash and be underweight in Global Equity. The Committee approved expanded asset class ranges in December 2008 to accommodate the misalignment of the portfolio relative to the existing policy targets and ranges.

Staff has worked with Wilshire, Pension Consulting Alliance (PCA) and Financial Engines to develop asset class assumptions for this exercise. Asset class assumptions were also sought from Callan and Mercer who are in the CalPERS consultant pool. Consensus was reached on the assumptions through discussion with the Senior Investment Officers, PCA, Wilshire and Financial Engines. The assumptions, sample portfolios and results from the preliminary optimization analysis are included in the attached presentation. Staff is seeking direction from the Committee primarily on:

- Inclusion of a policy target for cash going forward;

- Opportunistic allocation; and,

- Treatment of the Absolute Return Strategies (RMARS) Program.

The attached presentation also discusses:

A) Simplifying assumptions that underlie financial theory and asset allocation models: These assumptions are needed to develop theories and models, but they are an abstraction of real conditions which are much more complex. Staff believes that it is important to be aware of these assumptions during the asset allocation exercise.

B) Recent 10-year performance which is an anomaly compared to normal expectations and assumptions: The risk premium model which assumes that risky assets should generate incrementally higher returns has not held true in the recent decade although it still appears to hold for longer-term historical returns. The 2009 assumptions assume the risk premium model for expected returns going forward.

C) Asset allocation and risk diversification are not the same thing: Equities contribute a much larger share of Total Fund risk than their dollar allocation. Hence a balanced portfolio is less diversified in risk terms than it is in asset (dollar) terms. This insight needs to be borne in mind in evaluating portfolio diversification.

V. STRATEGIC PLAN:

This item addresses Strategic Plan Goals VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions; and IX, achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Policy asset allocation is the key determinant of risk and return for the Total Fund. Cost impact will be provided when recommendations are made in May 2009.

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Jay Jeong
Investment Officer

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Raymond Venner
Portfolio Manager

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Farouki Majeed
Senior Investment Officer-
Asset Allocation

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Joseph A. Dear
Chief Investment Officer